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Party in the USA

Why it might be time for US small-caps to have their moment in the spotlight...

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The Magnificent Seven have undoubtedly dominated the financial headlines in 2024 but they're by no means the only show in town when it comes to eye-catching returns.

Away from the spectacle of catching space rockets with giant chopsticks, the small-cap Russell 2000 Index quietly surpassed its larger-cap counterpart in the second half of 2024, posting an impressive six-month total return of 10% versus an 8% gain for the tech-heavy S&P 500, albeit with somewhat of a pullback in recent weeks.

This signals a notable shift in investor confidence due to a more supportive macroeconomic and political backdrop. After a challenging few years, Trump's pro-growth agenda and declining interest rates could lay the foundations for a sustained period of outperformance by the US small-cap sector.

Harnessing the macro tailwinds

The US small-cap sector is well-positioned to capitalise on macroeconomic tailwinds, with healthy jobs growth and rising wages driving robust consumer spending, alongside the start of a rate-cutting cycle.

Falling interest rates

The Federal Reserve surprised markets with a half-percentage-point interest rate cut in September, followed by two further cuts in November and December. While balancing inflation with economic growth remains a challenge, the Fed has signalled a more accommodative stance for 2025 with the possibility of additional rate cuts (albeit less aggressively than initially expected).

This falling rate environment is particularly beneficial for US small-caps, which often rely more heavily on debt financing than their larger counterparts.

The chart below shows that US small-caps have typically performed strongly during periods of low or declining interest rates, such as post the global financial crisis and pandemic, with the Russell 2000 rising in 2024 on the expectation of falling rates.

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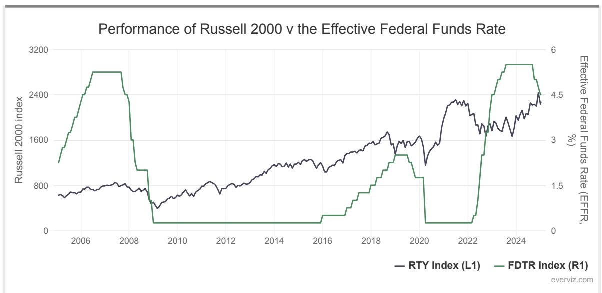
Fig.1: The Russell 2000 has performed strongly when rates fall



Source: Bloomberg (07/01/2025)

Pro-growth policies

The Trump administration's "America First" policy is likely to benefit small-caps which provide more concentrated exposure to the domestic economy than their larger-cap peers. According to FTSE Russell, Russell 2000 companies generate 80% of their revenue from the US, compared to 60% for the Russell 1000.

As a result, the Russell 2000 is often seen as a better proxy play on the domestic economy in the US. The incoming Trump administration has vowed to implement generous corporate tax cuts and deregulation, with optimism around pro-growth policies driving the Russell 2000 to an all-time intra-day high in November.

In addition, the likely introduction of trade tariffs could encourage US businesses to reshore supply chains and insulate domestic companies against competition from the likes of low-cost Asian manufacturers. A shift to localised sourcing is expected to particularly benefit the industrial, consumer discretionary and technology sectors, which represent significant weightings in the Russell 2000 Index.

Picking the winners

The US small-cap sector offers investors access to a dynamic investment universe, with the Russell 2000 accounting for around half of listed companies in the US.

These earlier-stage businesses often have superior growth trajectories compared to their large-cap counterparts: the Russell 2000 is projected to achieve 46% annual earnings growth in 2025, far exceeding the 12% forecast for the S&P 500, according to Yardeni.

While valuations remain attractive relative to historical averages, the small-cap sector has undergone a profound evolution over the last 20 years. According to Apollo, over 40% of Russell 2000 companies have negative earnings, compared to just 6% for the S&P 500. Additionally, passive capital has ballooned to an estimated 50% of the market, helping to prop up the unprofitable and lower quality businesses.

This underscores the importance of active management in identifying high-quality small-cap companies with the potential to become the large-cap success stories of tomorrow. Christopher Berrier, manager of **Brown Advisory US Smaller Companies (BASC)**, focuses on well-managed small-caps with durable growth, sound governance and scalable go-to-market strategies (the “3G filter”).

BASC’s ‘all-weather’ portfolio aims to deliver double-digit returns over the long term while managing downside risk. Christopher’s bottom-up stock-picking strategy prioritises companies with solid balance sheets, pricing power and superior growth potential.

One such example is Clear Secure which uses biometric identity technology to provide fast-track access through airport security, operating in some of the largest airports in the US including Chicago, New York and Los Angeles.

The company benefits from strong pricing power due to its dominant market share and the relative price inelasticity of frequent travellers willing to pay an annual fee for faster security clearance. It also has significant scalability potential, not only in domestic and international airports, but also by entering complementary markets with security protocols such as healthcare facilities and music and sports venues.

Clear Secure also highlights the need to accept potential volatility in order to capitalise on the attractive valuations of earlier-stage investments. While its post-IPO performance was mixed due to concerns over the sustainability of its business model,

Clear Secure’s growth potential has supported a share price increase of over 30% in the past year.

Taking a long-term view

Christopher runs a highly active strategy which can lead to periods of under-performance against the benchmark, particularly given the indiscriminate flow of passive capital into more speculative small-caps.

By way of example, Super Micro Computer and Bitcoin proxy play MicroStrategy contributed some stellar gains to the Russell 2000 in 2024 but the team decided not to invest in these companies due to a lack of alignment with their 3G filter. As mentioned earlier, the trust’s focus on less speculative, higher quality businesses should underpin long-term risk-adjusted returns irrespective of short-term divergence from the index.

Despite the recent period of relative underperformance, quality growth companies are well-positioned to lead the recovery in the US small-cap sector. A strong post-election rally has contributed to BASC delivering a six-month NAV return of 7% and a narrowing of the trust’s 8% discount could provide a further boost to returns.

Looking ahead, US small-caps offer a compelling opportunity for investors seeking diversification beyond the highly concentrated large-cap sector. With an improving macroeconomic and political backdrop, early-bird investors may be rewarded with their “party in the USA” if the current recovery continues to gain momentum.

All data as at 24/02/2025 unless specified otherwise.

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